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C O N F I D E N T I A L SECTION 01 OF 04 YEREVAN 000181

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SUBJECT: DONOR COMMUNITY GUARDED ABOUT ARMENIA'S ECONOMIC
RECOVERY

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Classified By: Ambassador Marie L. Yovanovitch. Reasons 1.4 (b/d)

SUMMARY

1. (C) An Embassy-hosted roundtable on the global financial crisis indicated increasing doubt in the donor community that Armenia will escape the worst impacts of the global financial crisis. Macroeconomic indicators continue to underperform initial predictions, and the GOAM has few tools at its disposal likely to aid recovery, given the external factors underlying Armenia's problems. Participants unanimously praised the Central Bank's (CBA) March 3 decision to let the Armenian Dram (AMD) float again, despite the possible inflationary impact of its large sudden devaluation. The banking sector remains stable, though its increased dollar-denominated lending creates a repayment risk. End Summary.

MACROECONOMIC INDICATORS WORSENING

2. (C) At a Donor Roundtable organized by USAID on March 5, representatives of the IMF, World Bank, IFC, EBRD and other institutions indicated that the situation in Armenia is worse than originally predicted, and that there is little prospect for near-term recovery. The IMF Resident Representative indicated that the Armenian economy has been in decline since September, but for some time the magnitude of this decline has been unclear; even in January the IMF projected five percent GDP growth for Armenia in 2009, but has since projected negative growth for the year. Armenia's GDP growth in recent years has rested on three legs: Growth in the construction sector; high prices for base metals (which constituted 40 percent of Armenia's exports); and high oil prices, which provided employment opportunities in Russia and remittances for Armenia. All of these turned negative at the same time; base metal and oil prices have fallen by two-thirds since their July 2008 peak, construction is now projected to decline in 2008, and remittances fell by 25 percent in January compared to January 2008.

3. (C) The IMF and World Bank had long opposed the CBA's support of the Armenian Dram (AMD), on which it spent at least USD 400 million since October before it announced March 3 that it would cease such intervention. Both had conditioned their assistance packages on the CBA ending this support. Despite pressing for this policy change, the IMF Resident Representative supported the CBA's (and Minister of Economy Nerses Yeritsian's) contention that the banking system would not have been prepared for a floating exchange rate in October, and that supporting the AMD for the past five months allowed banks to increase their capital and liquidity ratios.

4. (C) The CBA claims that if it had done a slow devaluation, people would still have panicked and abandoned the AMD.

Since the March 3 devaluation, however, there as yet has been no run on the banks, and the average AMD rate on March 5 was 363 per USD (up from 373 on March 3-4)--with bid/ask spreads ranging from seven to 25 Drams--and there is evidence that people are now selling dollars, which might help drive the Dram rate up slightly. However, the decline in foreign remittances, which are usually denominated in USD, will put fewer dollars into the economy and therefore put less upward pressure on the AMD. The IMF has advised against the CBA setting a target for the Dram.

15. (C) The immediate impact on prices resulting from the devaluation remains unclear. Prices for gasoline, all of which is imported and priced in USD, immediately increased by 20 percent or more, though those prices have since eased slightly. Retailers are under some pressure from the GOAM not to take unfair advantage of the devaluation to impose excessive price increases. Overall, the IMF now projects eight percent inflation for 2009 (up from 4-5 percent prior to the devaluation), based on a 20 percent devaluation and its estimate that the import sector accounts for 40 percent of the Armenian economy.

16. (C) February tax revenues fell 27 percent from the prior year, with the decline of the mining sector accounting for a major part of that decrease. Armenia's tax/GDP ratio is projected by the IMF to decline to 16.2 percent in 2009 (down from 16.4 percent by its own estimate, and 17 percent from the GOAM's). IMF is encouraging the GOAM to pursue large taxpayers more aggressively in order to make up revenue shortfalls; it has had some success with small taxpayers and retail outlets in recent months.

17. (U) National Statistical Service (NSS) figures now estimate unemployment at 6.5 percent, though in regions like

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Shirak and Syunik, the figure is closer to 12 percent. Unofficial estimates usually put the true unemployment rate at over 25 percent even before the financial crisis. Seventy percent of the unemployed are women, and sectors that traditionally employ women predominantly--such as hand-woven carpets--have been particularly hard hit by the economic crisis. Employment agencies say that demand for their services by the unemployed has risen.

I.T. SECTOR HIT, BUT CRISIS MAY CREATE OPPORTUNITY

18. (C) The information technology (IT) sector has been severely affected by the financial crisis due to its heavy dependence on exports and outsourcing of services, primarily to the U.S., Russia and Europe. IT companies can be viewed in three distinct groups: 1) Those directly affected due to customer slowdowns in affected export markets; 2) Those not connected to international markets in turmoil--mainly small local companies with local clientele; and 3) Those benefiting as foreign customers become more aggressive in outsourcing to reduce costs.

19. (C) Many IT firms have laid off staff due to the economic crisis, and the recovery in this sector should largely mirror that of its largest outsourcing markets. Some companies may benefit in 2009 from the cheaper AMD as foreign customers look to outsource to reduce their costs, and there is the possibility for increased demand for services in the local IT market, especially with the GOAM, which is planning more investments in IT education and e-government services. Another possible benefit from the current state of the IT market is that it is a buyer's market for software developers, and some of the more entrepreneurially-inclined may also venture out to establish their own companies.

BANKING SECTOR HEALTHY, BUT EMPHASIZING DOLLARS

10. (C) According to the Financial Sector Deepening Project (FSDP), another USAID implementer, banks currently account

for over 90 percent of assets in the financial sector. Total bank assets equal approximately 30 percent of Armenia's GDP, compared to 300 percent in Germany; consequently problems in the banking sector are less likely to influence the overall economy. Until quite recently, banks had continued lending: Loan portfolios grew over 40 percent in 2008. However, banks reduced significantly their lending in the construction and real estate sectors in the fourth quarter, as the value of many properties became less than their outstanding mortgages, interest rates rose, and banks generally tightened their lending standards.

¶11. (C) Even after the Dram devaluation, many banks are placing limits on the amount of dollars they will sell, or restricting such sales to their own customers. At the same time, an increase in dollar-denominated deposits--now 70 percent compared to 50 percent in the fourth quarter of 2008--has led many banks to denominate more of their loans in dollars. They are proposing dollar loans even to customers with AMD-denominated incomes, thus creating a major forex exposure for them and increasing the borrower's default risk. Banks have encouraged borrowing in USD because the market for hedging Dram/Dollar risk is still relatively undeveloped and hedging instruments are few and expensive (adding about four percentage points to the interest rate on an AMD loan). In an effort to discourage such dollarization, however, the CBA last week advised banks not to pay more than six percent for dollar deposits.

¶12. (C) Banks must also deal with a mismatch between deposit and lending terms, as 90 percent of bank deposits are demand deposits (and increasingly in USD). Banks take a major risk making long-term loans since those deposits can be withdrawn at any time. Armenian banks are also not good at pricing risk, and thus have not managed to balance the terms of their deposits with those of their loans. In order to mitigate this vulnerability, they need to diversify both the terms of their deposits and their loans.

¶13. (C) Overall, however, Armenian banks are relatively stable. The ratio of loans to available funds is a manageable 60 percent, and no banks are violating prudential requirements. According to IMF, banks had closed most of their forex positions and consequently lost just USD 10 million in the March 3 devaluation. Despite the relative health of the banking system, however, public confidence in the banking system is low. This is potentially problematic, as the Dram's value will rely in considerable part on public confidence in their deposits. While there is currently little prospect of a banking crisis, a loss of depositor confidence could cause a run on banks and consequently a fall

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in the AMD.

PROSPECTS FOR SME LENDING

¶14. (C) Several participants expressed doubts about the effectiveness of GOAM plans to help SME development during the economic crisis. While the falling AMD makes exports more competitive, demand may not exist for their products or services. Indeed, domestic demand for SME loans appears to be rather low, several participants noted, given high and rising interest rates and relatively few qualified SME loan applicants; KfW has to-date been able to find eligible borrowers for only about USD 12 million of USD 50 million it had available for SME lending, and others noted that with low level of financial sophistication in the regions, many potential borrowers simply lack the expertise to access the funds. Adding more liquidity into the system through the World Bank and IMF loans may therefore make little difference. Also, whether due to lack of demand or better alternatives, it is not clear how much banks will even lend to SMEs; before the devaluation, many found it more attractive to purchase government securities.

¶15. (C) Another problem for SMEs is that they must contend with government-protected monopolists on two levels: they present barriers to entry in many sectors of the economy, and also force SMEs to pay monopoly prices for inputs. Without a greater level of transparency and openness to competition in the economy, lending to SMEs may be of limited utility. Indeed, participants generally noted that there are relatively few viable loan recipients. This is a particularly vexing problem in the regions, where financial sophistication is low and there may be few borrowers who would understand how to pursue these funds. A better target for lending may be microfinance institutions, several participants suggested; they also continue to face strong demand for capital. IFC in particular is considering providing such funding.

GOAM RESPONSE TO CRISIS

¶16. (C) Besides its management of the Dram, and solicitation of funds from IFIs (USD 525 and 540 million from the World Bank and IMF, respectively) and Russia (USD 500 million, still to be approved), the GOAM is involved in several other efforts to bolster the economy. The Prime Minister is offering incentives to anyone willing to start a manufacturing operation, and the GOAM has initiated a financing program (featuring both loans and equity investments) for companies whose requests for assistance are accepted. These include: Sourcio, an IT company that received a AMD 125 million (USD 400,000) equity investment; food processing and herbal tea companies, and a USD 10 million loan for the Zangezour copper and molybdenum plant. Some donors, however--EBRD in particular--expressed skepticism about the GOAM's ability to make prudent equity investments.

¶17. (C) The GOAM has invested in some private-public partnerships (PPPs), including USD 20 million on the Tatev Tourist Center Project (near the famous but difficult-to-access Tatev Monastery), and 19 million Euros on a nuclear medicine center. The GOAM has also dropped duties and VAT on imports of over USD 1 million of IT and technology-related equipment, increased duties on imports of finished goods, and eliminated profit taxes on hand-woven carpets, in an effort to help rural and female employment.

¶18. (C) Despite the assistance to businesses, the GOAM seems to dismiss suggestions that it provide aid to the poor and unemployed through social assistance programs. At a donor coordination meeting two days earlier, Minister of Economy Nerses Yeritsian commented that the GOAM prefers to assist through loans to enterprises rather than to "pay people to sit at home."

COMMENT

¶19. (C) The GOAM is constrained in its ability to respond to the economic situation, given the small size of its economy and its vulnerability to exogenous economic forces. Allowing the AMD to float once again will undoubtedly wreak some short-term havoc (although so far, the losses have been contained) but will at least prevent the sending of false economic signals; also, the AMD is now back at about the same level it was two years ago, when there was no economic crisis. The CBA's management of the banking system appears still to be quite prudent, although the dollar lending introduces an element of repayment risk. With regard to active steps, even if the GOAM were inclined to make social

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payments, the GOAM's limited resources may prevent that from occurring on any meaningful scale, and it may well be better to use those funds to create jobs through infrastructure programs. Lending to SMEs, however, may be of questionable benefit in an economy plagued by high unemployment and low demand.

¶20. (C) The GOAM has also not yet addressed what it plans to do after the World Bank and IFI funds run out, which donors project will be 7-9 months, well before the current crisis is likely to end. Already the GOAM is proposing major budgetary restrictions due to lower-than-projected tax collections (to be reported septel). The GOAM may well need to turn once again, before the year is out, to the World Bank and other donors for assistance. End

Comment.

YOVANOVITCH